AMERICAN ARBITRATION ASSOCIATION

CALIFORNIA DEPARTMENT OF WATER RESOURCES	)	
	)	**Case No. 74 Y 198 00193 04 VSS**
vs.	)	
	)	**OPINION AND AWARD**
SEMPRA ENERGY RESOURCES	)	
	)	

Procedural Background

California Department of Water Resources, ("DWR") is an agency of the State of California. Sempra Energy Resources ("Sempra") is a California Corporation. On or about May 4, 2001, DWR and Sempra entered into a written Energy Purchase Agreement (hereinafter "Agreement") which contains a provision for arbitration, pursuant to the rules of the American Arbitration Association, of "all disputes arising under this Agreement" before a panel of three neutral arbitrators chosen pursuant to AAA rules. Various disputes arose between the parties and attempts at resolution have failed. On February 20, 2004, DWR instituted these proceedings by filing its Demand with AAA, and an Amended Demand on June 28, 2004. Thereafter an arbitration panel was duly designated, consisting of Samuel H. Porter as Chair, Hon. Edward A. Panelli (Ret.) and Hon. Joseph R. Grodin (Ret.).

A motion by Sempra for summary judgment or adjudication was denied. Both parties, under the Panel's oversight, conducted extensive discovery. On February 1, 2005, DWR, with the Panel's permission, filed a Second Amended Demand, which constitutes the basis for the present proceeding. A hearing originally scheduled for June 27, 2005 was postponed at the request of the parties. An evidentiary hearing in this matter took place before the Panel in the offices of the AAA in San Francisco, California, commencing November 7, 2005 and concluding, after eleven days of hearing, on November 21, 2005. DWR was represented at the hearings by Laura Zuckerman of the State of California Department of Justice, Office of the Attorney General, and by Alfred Pfeiffer, of the law firm Bingham McCutchen. Sempra was represented by Michael Hennigan, Laura Lindgren, Thomas B. Watson, and Robert W. Mockler of the law firm Hennigan, Bennett & Dorman LLP.

At the suggestion of the Panel, the parties filed post-hearing memoranda in response to various questions posed by the Panel, and on December 13, 2005, the parties met again with the Panel to clarify the issues and their positions. Thereafter, on or about February 3, 2006, the parties filed post-hearing briefs, and the matter was submitted for decision. To allow the

arbitrators adequate time to consider the voluminous record and briefs, and the unusually complex issues they presented, the parties stipulated to extend the time for the filing of an Opinion and Award until April 21, 2006.

Background

From May 2000 through the first half of 2001 California experienced a severe energy crisis, with shortages resulting in blackouts, unusually high prices, and substantial financial losses to the two principal California utilities supplying electric power. The California Legislature, meeting in an emergency session on January 31, 2001, enacted AB IX (codified at Cal. Water Code secs. 80000 et seq.), ordering DWR, on behalf of California's ratepayers, to enter into a portfolio of energy supply contracts in order to stabilize the market and restore grid operations. Pursuant to that mandate, DWR in the middle of 2001 entered into 56 long-term purchase contracts with various suppliers. The contract with Sempra is one of these.

After extensive negotiations, the Agreement between DWR and Sempra was entered into on May 4, 2001 for a term of approximately ten years. In brief, the Agreement requires Sempra to deliver designated amounts of electrical energy over the term of the Agreement, and for DWR to purchase and pay for that energy at specified prices, which, since June 1, 2003, include the cost of gas used to produce the energy. At its option, DWR may supply up to 80% of the gas required. The Agreement permits Sempra to deliver the Energy "from any Project, Market Source or combination of Projects and/or Market Sources" – a "Project" being a generating facility owned or operated by Sempra or an affiliate of Sempra's, either at the time or in the future – and to delivery that Energy at any "Delivery Point" as defined in the Agreement, or combination of Delivery Points, with Sempra being responsible for "any costs or charges imposed on or associated with the delivery of Energy up to the Delivery Point," and DWR for "any costs or charges imposed on or associated with the Energy at its receipt at and from the Delivery Point." (Section 2.01). The Agreement requires Sempra to provide annual and monthly delivery plans (Section 2.05), and an annual "Fuel Supply Plan" (Section 2.03), as hereinafter described. The Agreement also contains detailed provisions with respect to "Transmission Scheduling" (Section 2.04). Section 7.01 provides that "[a]ll disputes shall, to the extent possible, be settled in the first instance by discussions between senior officers of each of the Parties," and that if it cannot be settled within 30 days it may be referred to arbitration.

At the outset, DWR was responsible, on a temporary basis, for handling all aspects of contract administration, including the scheduling and dispatching of power, but by late 2002 the utilities were ready to resume power procurement responsibilities. Accordingly, on December 12, 2002, the California Public Utilities Commission issued an order allocating all power under the Agreement to Southern California Edison ("Edison"), and directing Edison to take over day-to-day responsibility for managing deliveries of power under the Agreement as DWR's "limited agent." Under the CPUC's orders, DWR retains legal title and financial responsibility for the Agreement, but Edison performs the day-to-day scheduling, dispatch, and administrative functions that DWR previously performed. Edison is required to manage the Agreement as an integrated

part of its portfolio, and to dispatch the resources in its portfolio on a least-cost basis. Edison uses the bulk of the energy to serve its customers, though it sometimes sells energy supplied by Sempra in certain limited situations. Ultimately, all costs associated with the Agreement are shared among the customers of the State's three largest utilities: Edison, PG&E, and San Diego Electric & Gas. Edison is not formally a party to this arbitration proceeding, but it was permitted to attend through its lawyers and representatives except during limited periods when confidential information (i.e. information which Sempra legitimately did not wish disclosed to Edison as a competitor) was being presented or discussed.

Issues Presented

DWR's Second Amended Complaint asserts that Sempra breached the Agreement in a number of different ways, and with respect to each of the breaches DWR claims damages. In addition, DWR contends that the breaches individually and collectively constitute a material breach justifying rescission, or in the alternative that it is entitled, in addition to damages for each breach, to declaratory relief to guide the future relationship of the parties. Accordingly, the issues are as follows:

I. Whether Sempra breached its obligations under Section 2.05 of the Agreement by failing to comply with its Annual and Monthly delivery plans.

II. Whether Sempra breached its obligations under Section 2.03 by failing to provide contractually adequate Fuel Supply Plans.

III. Whether Sempra breached its obligations under the Agreement by failing to provide energy in the quantities and product type contracted for (alleged "product splitting").

IV. Whether Sempra breached its obligation under the Agreement by delivering Energy to impermissible delivery points.

V. Whether Sempra breached its obligations under Section 2.04(c) of the Agreement (and/or the implied covenant of good faith and fair dealing) by delivering Energy to congested points.

VI. Whether Sempra breached the Agreement by improperly charging DWR for:

A. With respect to gas:

1. Arizona Fuel Taxes

2. Sempra Energy Trading (SET) fees for scheduling, nominating, balancing

3. Downstream transportation and distribution charges

4. Above-market prices for gas and transportation

B. With respect to energy:

1. Mexicali transmission losses

2. Energy undelivered due to plant outages

VII. To the extent that Sempra has breached the Agreement in any of the foregoing respects, what remedies, if any, are appropriate among the following: (a) monetary damages; (b) declaratory relief; (c) rescission.

Overall Positions of the Parties

In addition to and in support of their arguments pertaining to specific issues, each Party makes certain general observations about the nature and context of the Agreement. Sempra observes that in agreeing to meet DWR's insistence upon firm commitments for the delivery of Energy and the "shaping" of the deliveries (so as to accommodate DWR's demand for delivery of substantially more energy during on-peak hours, and during months that DWR did not have access to less expensive power) Sempra assumed substantial risks, especially in light of uncertainties associated with the building and operation of new power plants that were required to meet these obligations; that in exchange for these risks Sempra bargained for and obtained substantial flexibility and discretion; and that the Agreement should be interpreted in that light. DWR, on the other hand, points to language in that Agreement which it argues limits Sempra's flexibility and discretion, and contends that Sempra's assumption of virtually unlimited discretion in the administration of the Agreement reflects a consistent pattern of bad faith that justifies termination of the relationship. The Panel has considered these overall arguments in assessing the merits of individual issues.

I. Sempra's Alleged Failure to Comply with Annual and Monthly Delivery Plans

Section 2.05 *of the agreement provides in relevant part:*

(a) Annual Delivery Plan. Within ten (10) Business Days of the execution of this Agreement for Summer 2001 and no less than ninety (90) days before the end of each calendar year of the Term thereafter, SER shall deliver to Department . . . a description of planned deliveries of Energy over the upcoming year (the "Annual Energy Delivery Plan") indicating the intended Delivery Points and the amounts of Energy to be provided at each Delivery Point for each month, on-peak and off-peak, considering but not limited to:

(i) outage schedules for the Projects;
(ii) any known changes in Project availability;
(iii) known or anticipated transmission constraints requiring modification

of operations compared to the prior year's operations;
(iv) status of contracts between any Seller and others for firm sales from the Projects which could impact ability or schedule for deliveries from the respective Projects; and
(v) Natural Gas transportation or other factors which influence preferred sources of generation and associated points of delivery.

Department shall provide its comments on the Annual Energy Delivery Plan within thirty (30) days of receipt for the purposes of any recommendations for revisions in delivery plans and to accommodate preferred fuel supply plans. SER shall make commercially reasonable efforts to accommodate the requested revisions.

(b) Monthly Energy Delivery Plan. No less than five (5) days prior to the commencement of each month, SER shall deliver to Department . . . a description of planned deliveries of Energy in the upcoming month. . . indicating the amounts and Delivery Points for such Delivery Points of Energy. All Energy to be provided from the Projects, Market Sources and/or any combination of the Projects and Market Sources shall be scheduled in accordance with Section 2.05(c). Any material deviations from the most recent Annual Energy Plan shall be noted and reasons for the change explained. Within two (2) business days of receipt of the Monthly Energy Delivery Plan, Department shall note any exceptions or requested modifications to the Monthly Energy Delivery Plan. SER shall make commercially reasonable efforts to accommodate revisions requested by Department.

(c) Energy Scheduling Generally. Seller may deliver all or part of the Energy to any Delivery Point regardless of whether such Energy is generated at a Project associated with such Delivery Point or obtained from Market Sources and without regard to the Maximum Capacity at the Delivery Point scheduled for any Project. Except as provided in Section 2.04(c), Seller shall, in accordance with standard operating practices and the Annual Delivery Plan and Monthly Energy Delivery Plan promulgated in accordance with this Section 2.05, deliver to Department . . . on each Business Day a notice indicating the Delivery Points and the amounts of Energy to be provided at such Delivery Points for each hour of the time period commencing on the next day and extending through and including the next Business Day.

Commencing on or about April 19, 2002, DWR began to complain that Sempra was deviating from its Monthly Energy Delivery Plan by changing delivery points on no more than a day's notice, in violation of the contractual requirement to deliver "in accordance with" the plan, resulting in operational difficulties and additional costs. According to DWR's experts, the energy delivery plans allow for DWR to set up grid operations in such a way as to make sure that the

energy can be utilized within the grid and delivered in a reliable fashion, and to "hedge" in a timely fashion by arranging to obtain energy from other suppliers, and Sempra does not dispute those general observations.

While the parties dispute the extent of deviations and their monetary consequences, there is little doubt that substantial deviations did occur. Indeed, it is clear from the record that Sempra did not consider itself constrained, by the annual or monthly plans, in the making of daily schedules. William Engelbrecht, vice president of supply for Sempra and contract administrator for the DWR contract, testified that Sempra's view of the annual and monthly plans was that they were "estimates" and "non-binding," and his response to DWR's April, 2002 complaint was to include language to that effect in the plans. He testified that "If . . . absolutely nothing changes, then ... [the] monthly plan will look identical on a monthly basis to what is said in the annual plan," and "if absolutely nothing changes and every day throughout that month it looks identical from all that data, then the daily notices will not change at all either," but that Sempra considers itself free to deviate from the plans in response to any changes, including market prices for gas. Connie Lee, who is responsible for sending two-day-ahead schedules for Sempra, testified similarly that in constructing the daily plans she considers "all the factors," including price changes, other obligations that Sempra might have, in addition to plant outages.

The difference between the parties on this issue depends on the meaning of the requirement in Section 2.05 that Sempra's daily notices of delivery be "*in accordance with* standard operating practices and the Annual Delivery Plan and Monthly Energy Delivery Plan." Sempra contends that the italicized language means only that it must use the same "protocols" in constructing the daily notice as it used in constructing the annual and monthly plans – meaning, in effect, that Sempra has total discretion to alter the plans on the basis of any or all of the factors which it says it takes into consideration in constructing all the plans, including price variations and Sempra's other obligations. There are, however, a number of difficulties with this interpretation.

First, Sempra's view of the meaning of the disputed language seems at odds with common usage. "Accordance" normally means "agreement, conformity" (American Heritage Dictionary, 4th Ed. 2000).

Second, and more significantly, the term "in accordance with" in the context of the sentence in which it is used plainly refers to the plans themselves, not to some unidentified "protocols." If the parties intended to bind Sempra only to certain protocols, or procedures, instead of to the substance of the plans, it seems likely that they would have used different language to express that intent.

Third, Sempra's interpretation is difficult to square with other provisions of Section 2.05. Section 2.05(a) obligates Sempra to make commercially reasonable efforts to accommodate requests by DWR for revisions to the Annual Delivery Plan. And Section 2.05(b) obligates Sempra with respect to the monthly plan to explain any deviations from the annual plan, as well as

to make commercially reasonable efforts to accommodate revision requests. If neither the annual plan nor the monthly plan constrained Sempra with respect to daily deliveries of energy, accommodation of revision requests would seem to have little meaning.

Finally, Sempra's interpretation is inconsistent with the purpose which the disputed language of Section 2.05 was intended to serve. Early drafts of the Agreement contained provision only for daily plans. The requirement for annual and monthly plans in its final form was in response to DWR's insistence upon adequate notice to enable it to plan fuel and electricity deliveries. Little purpose would be served by a requirement for annual and monthly plans which could be changed at the last minute to maximize Sempra's profit.

Sempra advances a number of contrary arguments. First, it argues that while Sempra's monthly plans show energy deliveries for a typical day it is not obligated to do that, and if instead the monthly plans simply showed the total amount of energy to be delivered at various points during the month DWR would have had nothing to complain about. This argument is advanced for the first time in Sempra's post hearing brief, which cites in support to the testimony of Sempra's expert Ellen Wolfe who, in response to a question as to her interpretation of the plan requirements, said it was unclear to her whether the plan required "an hourly specification of what the energy deliveries are or whether the plan represents typical deliveries of what the energy is from hour to hour, or whether the plan might have included a cumulative amount of energy to be delivered over the month." An expert's expressed belief as to what the plan "might have included," however, is not helpful in determining the meaning of the plan requirement, and Sempra itself has apparently interpreted Section 2.05 to require the information which it includes in the monthly plan.

Second, it argues that "industry practice" supports its position that when parties intend for plans to be binding, they will typically include performance criteria, such as is contained in DWR's contract with Coral. Sempra's expert Ms. Wolfe testified generally to that effect, but it casts scant light on what the parties meant by the language they included in this contract.

Third, Sempra points to the fact that DWR concedes that some deviations from the annual and monthly plans are impliedly permissible, and this is true. DWR in its post-hearing brief concedes that deviations from the annual plan are impliedly permissible in the case of changes in outage schedules for the Projects, changes in Project availability, or anticipated transmission constraints, and that deviations from the monthly plan are similarly permissible in the case of transmission curtailments or interruptions or planned outages. But the fact that DWR is willing to acknowledge such reasonable qualifications to the "in accordance with" requirement does not support Sempra's position that, in effect, anything goes.

Finally, Sempra points to a memorandum introduced as Exhibit 49 which comes from Edison files and appears to be a synopsis of the Agreement and which contains a reference to the annual and monthly plans as "non-binding estimates," and to another internal memorandum introduced as Exhibit 625, which states with respect to Energy plans:

> Sempra's intended daily schedules for each year are provided prior to the start of each year and updated by Sempra as necessary prior to the start of each month. The yearly and monthly plans include outage schedules for the projects covered by the contract, projected transmission constraints (if any) , and other electric power and/or fuel related issues that might impact deliveries under the contract.

Assuming these memoranda were intended to reflect the view of Edison managers at the time (see below) neither of them are inconsistent with DWR's position that deviations from the plans are permissible for reasons beyond Sempra's control. Viewed against the backdrop of the contract language and the totality of the circumstances, the Panel does not find these memoranda persuasive of Sempra's position.

The Panel concludes that on this issue DWR's position is essentially correct, and that variations from the annual and monthly plans are not permissible except when due to circumstances, such as those conceded by DWR, which are beyond Sempra's control. DWR would have the Panel go beyond such a declaration and provide a protocol for dealing with such contingencies when or before they arise, but the Panel considers it would be best to leave such procedural matters to discussions between the Parties, and to the dispute provisions of the Agreement should unresolvable issues develop.

Damages

DWR seeks damages for deviations from monthly energy plans on the following theories. First, it seeks to recover for the value which its expert claims the energy would have had if it had been delivered, as expected, in a month-long block of energy ("lost monthly forward premium") – an amount calculated to be approximately $4.1 million. Second, it seeks to recover for what its expert calls "lost daily liquidity premium" due to last-minute changes in delivery plans, requiring DWR to "dump" energy at depressed prices – an amount calculated to be approximately $300,000. Finally, it seeks damages based on the lower value of energy delivered, through deviations from the plan, at congested areas ("damages from movement to lower priced delivery points"), calculated by DWR's experts to be $6.2 million.

Sempra criticizes the "lost monthly forward premium" calculation on the ground, principally, that it is speculative, there being no evidence that the power in issue was actually sold, or that Edison or DWR ever sought to sell power month-ahead or made any plans to do so. DWR responds that this is irrelevant, the expert's calculation being on a "but-for" basis.

Sempra criticizes the data used by DWR's expert, Hanser, to support the calculation of "damages from movement to lower priced delivery points" (the Dow Jones Day-Ahead index) on the ground that it does not accurately measure sales prices at Sempra delivery points – that it is simply a survey-based reporting of prices at which some bilateral transactions cleared over multiple-hour blocks, and that it does not include most of the scheduling points where Sempra

delivered power. Sempra maintains that the only proper measure of damages for disallowed deviations would be additional congestion costs incurred to import power to SP15 from the day-ahead delivery point that varied from that in the monthly plan – an amount which its expert calculates to be $1,506,554.

The Panel agrees with Sempra that the damage calculations submitted by DWR are overly speculative, and that the appropriate measure of damages would be as Sempra suggests. While Sempra insists that the additional congestion charges are not properly recoverable by DWR because they were incurred by Edison, the Panel disagrees, since Edison was acting as DWR's agent. And while Sempra observes that this figure does not take into account concededly permissible movements due to plant outages or transmission capacity reductions, Sempra's expert provides no basis for calculating that, presumably small, reduction. The Panel concludes that DWR is entitled to recover in the amount of $1,506,554 for Sempra's breach, but not pre-award interest. (See Cal. Civil Code Sec. 3287(b)).

II. Sempra's Alleged Failure to Provide Adequate Fuel Supply Plans

The Panel inquired of the parties to respond in their December 13, 2005 memorandum as to what should be the criteria for determining the adequacy of SER's Fuel Supply Plan with respect to pricing and delivery. DWR responded by saying the adequacy of the annual Fuel Supply Plans should be determined using the following criteria:

Pricing

Did Sempra's Fuel Supply Plan provide pricing for natural gas and associated transportation, distribution, storage and/or other delivery services such that:

1. DWR could ascertain the expected cost of Sempra-supplied gas;

2. DWR could engage in a meaningful competitive bid process;

3. DWR could compare that expected cost to the expected cost of DWR's self-supply in order to make an informed election as to the mix of supply and the cost of supply that would yield the lowest expected cost for California rate payers;

4. Was the pricing, at a minimum, good faith indicative pricing that was held open for some reasonable period of time, and that, even if refreshed prior to DWR's election became firm pricing for the year as of the date DWR made its election.

Delivery

The adequacy of the delivery information provided in the annual Fuel Supply Plans should be determined based on the following criteria:

Did the Fuel Supply Plan provide delivery information such that DWR could ascertain the expected cost of Sempra's supply;

DWR could solicit cost-minimizing competitive bids;

DWR could compare expected costs in order to make an informed election regarding the mix of supply that would produce the lowest expected cost for California's rate payers;

Did the delivery information include, at a minimum, the required volumes associated with each different price of gas and related services in the Fuel Supply Plan, as well as the volumes going to each delivery point.

It is DWR's position that the function of 2.03 was to allow DWR to make an informed annual election that produces the lowest expected cost for natural gas. It said that it bargained for:

1. A requirement that Sempra deliver a written annual Fuel Supply Plan 90 days in advance of the new year;

2. That the Fuel Supply Plan contain sufficient information to allow DWR to ascertain the expected cost of the CGR;

3. Option for DWR to self-supply up to 80 percent of the CGR.

DWR argues that good faith indicative pricing, whether fixed or index-based, would need to be firm for the year at the time DWR made its election.

DWR argues that with respect to delivery information the Fuel Supply Plan must set forth the monthly delivery point and volume information. Prices must be tied to the intended volume and DWR needs to know the volume going to each delivery point in order to solicit cost-minimizing competitive bids. Since competitive bids sometimes differentiate pricing by delivery points, DWR needs to know the volume going to each delivery point.

DWR argues that requiring Sempra to provide delivery information does not impose an unacceptable risk because the volume of gas assigned to each delivery point in the Fuel Supply Plan is to be based upon planned energy deliveries.

DWR takes the position that the criteria it believes must be followed are compatible with Section 2.03(a)'s "unacceptable risk" provision.

It is DWR's position that the record in this case shows that Sempra had no intention to commit to any price in the Fuel Supply Plan. It intended to charge DWR whatever it paid SET.

Sempra's position in its December 13, 2005 responses to the Panel's questions:

Sempra takes the position that it satisfied the requirements of the Fuel Supply Plan. It provided the current forward prices and current index-based prices for gas for each identified supply basin that could be a source of natural gas. It says it also identified the specific associated charges, including transportation costs set by applicable tariff, which would be incurred by Sempra for purchase of gas at each of the delivery points and the particular Sempra projects. It says that this information allowed DWR to ascertain its expected costs at the prevailing market rates and identified delivery and transportation charges.

Sempra says that it provided DWR information and opportunity to "lock-in" pricing for all or a portion of the CGR by offering options of index pricing, forward pricing, or fixed pricing, any of which would have allowed DWR to ascertain the expected cost of natural gas.

As an example Sempra points to its offer of a fixed price for the 2004 Fuel Supply Plan, which at the time was $5.55 including all costs to the burner tip. Had DWR agreed Sempra says DWR would have known its total costs for gas.

Sempra asserts that the Fuel Supply Plan does not require a proposal or bid, rather, the Fuel Supply Plan is to provide information as to how Sempra intends to procure gas.

Sempra says that DWR was critical that the pricing in the Fuel Supply Plan was indicative and that the actual cost could be higher or lower. Sempra says DWR agreed that index pricing was permissible.

Sempra says that DWR complained that the Fuel Supply Plan did not contain offers that DWR could accept at any time during the 90-day period provided for DWR to elect whether to self-supply. It says the Agreement does not require the Fuel Supply Plan to include any binding offers or options. It was a risk Sempra was not willing to take.

With respect to deliveries, Sempra says that there is no requirement that Sempra specify quantities of gas for each of the delivery points. It quotes from Section 2.03(a) that Sempra is not required to adopt a Fuel Supply Plan that:

> "Could interfere with its ability to provide the energy from any combination of the projects and/or market sources; or ... expose Sempra to risks, including credit, market or delivery risks."

Further, if DWR elects to self-supply, the gas must be delivered "to one or more of the following natural gas delivery points, as directed solely by the Seller ...1.01 Southern California Border Point."

Sempra says that designating a year in advance would necessarily expose Sempra to credit, market and delivery risks. It says it explicitly bargained to avoid these risks.

Sempra takes the position that DWR has not carried its burden of proving that Sempra's Fuel Supply Plan in any way prevents DWR from making informed decisions regarding its self-supply option or obtaining alternative market rate bids to supply the Sempra gas.

Sempra in its post arbitration brief says that Sempra proposed in each Fuel Supply Plan to lock-in pricing for all or a portion of the CGR by offering DWR options of index pricing or forward pricing in addition to fixed price offers. It says that any of these options would allow DWR to ascertain the expected cost of the natural gas.

Discussion

2.03 requires Sempra to submit 90 days in advance of the effective date of the Fuel Supply Plan a Fuel Supply Plan for the balance of the year in the case of 2003 and for the year 2004 and each subsequent year.

Sempra has virtually unlimited discretion in how it acquires or supplies the natural gas to meet its requirement with respect to the CGR.

In actuality Sempra turns over to SET the business of acquiring, scheduling, transporting, delivering the natural gas to Sempra in an amount necessary to meet Sempra's obligation to provide its share of the CGR.

What method or programs are utilized by SET in carrying out its responsibilities is not part of the record. The record lacks any information as to how SET buys, what it pays, how it schedules and delivers the natural gas to Sempra. Nor does the record show how SET, who is providing the same service of providing all of Sempra's natural gas requirements, not just the energy for DWR, allocated the costs between users of the natural gas.

DWR receives a bill from Sempra which is a pass through of Sempra's payments to SET. DWR does not know what SET did or how it went about supplying and paying for the natural gas, or how costs were allocated.

Sempra says that it monitors SET's activity to ensure itself that it is acquiring the natural gas at the least cost. More than one Sempra witness stated it was their objective to acquire the natural gas at the least cost and, while this may be Sempra's objective, the record does not provide persuasive evidence on this point. Further, this objective is not particularly relevant to the issue before the Panel, that is, did the Fuel Supply Plan permit DWR to ascertain the expected cost of the natural gas needed to generate energy sold under the Agreement during the fuel supply year. 2.03(a).

Sempra's obligation was to provide a Fuel Supply Plan setting forth how it planned to procure gas, follow that plan during the fuel supply year, and provide information to DWR so that DWR can ascertain the cost of the natural gas being supplied by Sempra.

Sempra's Fuel Supply Plan does not have to be acceptable to DWR. Although it is Sempra's program which is to be followed by Sempra during the fuel supply year, it was not required to include in its Fuel Supply Plan any binding offer or options.

Sempra says that DWR could have selected an option so that it would know its cost. Certainly, it is not DWR's obligation to pick an option that would permit it to ascertain its costs. It is Sempra's obligation to present a Fuel Supply Plan that permits DWR to ascertain the costs of the gas to DWR, not a series of non-binding options.

Although the Fuel Supply Plan may have provided options which, if selected, may have resulted in more certainty, we are still left with the provisions in the Fuel Supply Plan as interpreted by Sempra that prices are "indicative only" and Sempra "takes on no risks."

In actuality the 2004 Fuel Supply Plan (Exhibit 418 at DWRA 0000583) says that Sempra would consider providing natural gas "for all or a part of the CGR at a fixed burner price" so long as Sempra "was not exposed to any unacceptable market and/or credit risks." "Currently the prices (subject to change) for this price option would be $5.55 MMBtu." It is not a firm offer.

Based upon a reading of the Fuel Supply Plan this was not a fixed price in the sense that it would be DWR's price during the fuel supply year. It was subject to change, was indicative only, and had certain conditions including that Sempra not be exposed to risk. The record is clear in this case that Sempra did not commit itself in the Fuel Supply Plan to a plan that permitted DWR to ascertain its costs.

Sempra continued to posit as late as its post-hearing brief about meeting its obligation by providing the natural gas at prevailing market rates. This does not meet the requirements of 2.03.

The purpose of the Agreement between DWR and Sempra is to provide a reliable source of power through DWR to consumers in the State of California. The concept set forth in the Agreement is straight forward. Sempra agrees to provide to DWR a fixed number of megawatts through September 30, 2011. DWR agrees to pay a particular amount for those megawatts. In order to provide the megawatts it is necessary for natural gas to be purchased. Included within the payment by DWR to Sempra is payment for the cost of gas required to be provided by Sempra to "generate the energy" sold during the calendar month calculated in accordance with the formula contained in Section 2.03(c).

No later than 30 days prior to the commencement of an upcoming fuel supply year, DWR may elect to provide up to 80 percent of the contractual gas requirement for the upcoming fuel supply year. If it elects to provide some part of the contractual gas requirement, it is to deliver the natural gas in amounts and at times "coincident with seller's obligation to delivery energy." The natural gas is to be delivered to a defined delivery point as directed solely by Sempra.

Even though Sempra is not required to use the specific CGR gas provided by Sempra or DWR in its production of energy for DWR from its power plants, it is clear that the CGR is directly related to the amount of energy that must be provided by Sempra to DWR as specified in Appendix C of the Agreement. Where Sempra gets the gas and how it uses it is left to Sempra.

Sempra provided substantial testimony in this proceeding that the natural gas supplied was used in the production of energy at Sempra's plants. It also provided testimony that in the future there would be an even closer relationship between the supply of gas provided to meet the CGR and its consumption at Sempra's plants to produce energy for DWR.

We have discussed elsewhere in our Opinion/Award the responsibility of Sempra with respect to its providing energy delivery plans. Compliance with the Fuel Supply Plans and the energy delivery plans are related. Although Sempra has discretion as to where DWR is to deliver its supplied gas, Sempra has the responsibility to provide in its Fuel Supply Plan a reasonable, good faith effort to provide to DWR the necessary information concerning where the gas is to be delivered during the fuel supply year consistent with the energy delivery plan submitted pursuant to 2.05.

No gas supply proposals from SET or any of the other gas suppliers are provided by Sempra to DWR. At the same time Sempra has claimed the right not to assume any impermissible risk and has used that provision of the Agreement to avoid committing to any program which permits ascertainment of the costs of the natural gas needed to meet its obligation.

DWR bargained for and received the right to know what the CGR cost would be to it annually.

Decision

The parties are required to act in accordance with industry standards and norms as well as act in good faith. In this situation this means there must be an annual Fuel Supply Plan provided by Sempra and it must have certainty, to the extent possible, as to how the cost of gas is to be priced to the burner tip.

We find that under the terms of the Agreement taken as a whole, Sempra in its annual Fuel Supply Plan must provide a plan which permits DWR to ascertain the cost to it of the natural gas. This can be done by Sempra soliciting bids from its suppliers, including SET. There may be many other ways available to Sempra to fulfill this obligation but, clearly, this is an acceptable method of determining the cost.

Sempra retains the right to select a plan but it must follow the plan selected. The plan selected needs to take into account Sempra's rights under Section 2.03(c) with respect to risk, but those rights are subject to their being exercised in good faith and in light of industry standards dealing with natural gas procurement and delivery to the burner tip in accordance with the energy

delivery plan and Fuel Supply Plan. Also, the Fuel Supply Plan needs to identify, consistent with industry standards and norms and Sempra's rights as described above, volumes going to delivery points in the event of DWR's selection to self-supply.

We conclude that Sempra breached its obligations under Section 2.03 of the Agreement by failing to provide contractually adequate Fuel Supply Plans. There remains the question of remedy. The Panel concludes that DWR has failed to provide sufficient basis for an award of damages. Formulating declaratory relief is complicated. DWR proposed that the Panel undertake to declare precisely what Sempra must do in order to satisfy its obligation to provide a basis for predicting costs, but because of the range of alternatives, and the complexities involved, we do not consider it appropriate for the Panel to do so. Rather we will direct the parties to meet and confer over this issue. Sempra, in order to avoid continuing breach, must be more transparent in its dealings with its principal gas supplier and affiliate, SET, and more forthcoming in suggesting meaningful ways of enable DWR to estimate gas costs on a reliable basis. We observe, in that connection, that the provision for pass-through of gas costs should protect Sempra against significant risk with respect to most alternatives. We also observe that DWR may not sit passively on the sidelines waiting for Sempra to propose an accept plan; it must cooperate with Sempra to that end on an ongoing b basis.

III. Sempra's Alleged Failure to Provide Energy in Appropriate Quantities and Product Type ("Product-Splitting")

DWR complains that Sempra has breached the Agreement by breaking up (splitting) the delivery of the 7 x 24 base load energy with multiple non-standard components of "on-peak" and "off-peak" power. DWR, as with all its claims, has the burden of persuasion on this issue. The Panel concludes that it has not satisfied its burden on this issue.

Section 2.01 of the Agreement requires Sempra to sell and DWR to buy "Energy." The Energy to be sold and the pricing of that Energy is set forth in Exhibit C of the Agreement. Appendix C establishes a price for 7 x 24 Capacity energy and a price of 6 x 16 Capacity energy. The Agreement requires Sempra to deliver 7 x 24 or "base load" energy for each hour of each day of the week. In addition, during peak hours, occurring six days a week for 16 hours (6 x 16), Sempra must supply additional energy. DWR contends that the pricing mechanism in Appendix C reflects an agreement that the same priced power, i.e. 7 x 24 and 6 x 16 be delivered to the same delivery point for each hour of every day. DWR supports its interpretation with reference to both the negotiation history and industry practice.

The negotiation history relied upon is based upon the testimony of Mr. Nichols. His testimony consists of some very general statements that "DWR was to receive 7 x 24 and 6 x 16 products." In the view of Mr. Nichols, the issue of "splitting" was never discussed during the negotiations because in his view it was unnecessary since they were buying 7 x 24 and 6 x 16 products. (Tr. p. 209: 13-24; 210; 1-5.) However, his testimony in this regard did not address the

manner in which the "products" could or must be delivered. The Panel does not find this testimony persuasive or helpful.

DWR also relies upon industry usage of the term 7 x 24 energy or base load capacity product to support its contention. DWR witnesses testified that the commonly understood meaning of the term "7 x 24" in the electric power industry meant "energy that is typically delivered at a constant quantity seven days a week, 24 hours a day, to a single delivery point." They argue, in accordance with industry usage, that 7 x 24 energy is a "product." However, defining "7 x 24" energy as a "product" does not control deliveries. "On peak" and "off peak" are also "products." Deliveries that the contract provisions allow is what is at issue. One must therefore look to the Agreement itself.

Sempra responds that Appendix C is nothing more than a pricing formula for Energy and does not require the same price energy to be delivered to the same delivery point. As Mr. Engelbrecht testified, the "term 7 x 24 or base load, and 6 x 16 or on peak are used in the contract from a pricing perspective. Those terms have nothing to do with how we [Sempra] deliver the energy from a delivery point standpoint." (Tr. 711:22-25.) In addition, Sempra contends that pursuant to the provisions of Sections 2.01 and 2.05 of the Agreement, Sempra is permitted to deliver the 7 x 24 base load energy in "on peak" and "off peak" components by delivering them to different delivery points. The Panel finds that Sempra's position on this issue finds support in the Agreement.

Section 2.05 of the Agreement permits Sempra to deliver "all or part of the Energy to any Delivery Point." Section 2.01 permits Sempra to deliver "Energy at any Delivery Point or combination of Delivery Points." These provisions give Sempra a great deal of flexibility in the manner of its delivery of energy called for in the Agreement. Moreover, Sempra's position is further supported by the energy plans required under the Agreement. Section 2.05(a) requires Sempra to provide "a description of planned deliveries...on peak and off peak." The parties clearly understood that 7 x 24 energy includes both peak and off peak power. It would not appear reasonable to require Sempra to deliver base load priced energy to the same set of delivery points when under Section 2.05(a), the annual plan splits the deliveries into on peak and off peak periods. Section 2.05(c) also lends support to Sempra. That section calls for an hourly schedule of energy. Under Section 2.05(c), the following is required of Sempra: "on each business day a notice indicating Delivery Points and the amount of Energy to be provided at such Delivery Points for each hour of the time period commencing on the next day and extending through and including the next business day." Mr. Engelbrecht testified as follows with respect to its energy deliveries: "So, we deliver the energy every hour, and by delivery point. So, when we provide our daily notices, as it shows clearly in 2.05(c), we are providing that energy schedule by delivery point by quantity, by hour for the next delivery day." In view of the provisions of Section 2.05(c), Sempra correctly argues that if it were required to deliver base load energy to the same point all month, as DWR suggests, there would be no need to set out hourly delivery schedules by quantity. The language of 2.05(c) would be unnecessary. We believe that Engelbrecht's explanation is a reasonable interpretation of the Agreement and makes sense.

The Panel therefore concludes that Sempra's manner of delivery of Energy is not in breach of the Agreement.

IV. Sempra's Alleged Delivery to Impermissible Delivery Points

DWR contends that Sempra has breached the Agreement in that Sempra has delivered market source energy to impermissible delivery points. Under the Agreement Sempra is permitted to deliver energy to delivery points identified in Appendix B of the Agreement. Section 2.01 of the Agreement provides:

> "Seller may provide the Energy from any Project, Market Source or combination of Projects and/or Market Sources and may deliver Energy at any Delivery Point or combination of Delivery Points."

"Delivery Point" is defined in the Agreement as any of the points of delivery listed in Appendix B, (Column (D)). Column D of Appendix B provides that from Market Sources, the Delivery Points are the "Cal ISO Delivery Points." The Cal ISO Delivery Points are, in turn, defined as "any point on the transmission grid currently controlled by Cal ISO and any scheduling point of the Cal ISO."

Sempra contends that this definition permits it to deliver energy to any scheduling point of Cal ISO, while DWR contends that Sempra's deliveries must be both Cal ISO scheduling points as well as points on the grid controlled by the Cal ISO. It is Sempra's contention that the plain language of this provision supports its interpretation. While DWR does not agree with Sempra's position, it does concede that the definition of Cal ISO Delivery Points is less than artful. It is the view of the Panel that a plain reading of this provision supports Sempra's interpretation. Accordingly, the Panel concludes that the reasonable interpretation of the contract language "any point on the transmission grid currently controlled by Cal ISO and any scheduling point of the Cal ISO" permits Sempra to deliver both to points on the transmission grid and to Cal ISO scheduling points.

Cal ISO "scheduling points" are defined by Cal ISO as points where power enters the grid from control areas at the boundaries of the Cal ISO grid. Those points, which are listed in the Cal ISO scheduling documentation include the points Palo Verde COB, NOB, etc., where Sempra has delivered energy. Further, Jesse Bryson, the DWR Contract Administrator at Edison acknowledged that a scheduling point of the Cal ISO is a point where a "party" can schedule energy to the ISO. (Tr. 393:21-394.1) Importantly, and supportive of Sempra's position, the individuals most responsible for, and charged with administering the contract, understood and interpreted the language of the Agreement itself in carrying out their duties to mean that "Cal ISO Scheduling Points" are permitted delivery points. Susan Lee, another DWR Contract Administrator, advised Pete Garris, her supervisor, in an email that "Sempra has the right to deliver to COB, or any delivery point that connects to the Cal ISO grid under the contract." (Exhibit 104) Whether Mr. Garris agreed with this assessment is unclear as he did not recall telling her he agreed or disagreed with her. Unfortunately, his response to this email was redacted. (Tr. 102: 1-103.1)

As further support for Sempra's interpretation of the Agreement, Mr. Bryson, at the time he started his job as a Contract Administrator, was provided with a document, Exhibit 48, which was a contract summary of the Sempra Agreement. He testified that he was uncertain of the author and the date of the document is uncertain. However, he admitted it was prepared by someone in his organization. He also identified Exhibit 49, which was also a contract synopsis of the Sempra agreement. It is very similar to Exhibit 48 with respect to delivery points. Exhibit 46 is also a summary of the Sempra Agreement. This exhibit is dated August 18, 2003. When Mr. Bryson was asked whether he prepared Exhibit 46, he answered, "it was prepared under my supervision." He further testified that he reviewed it and was familiar with its contents. These documents, Exhibits 46, 48, 49, were prepared so that Edison could properly perform under the Agreement. These exhibits prepared by Edison all confirm that Sempra can deliver "at any ISO delivery point." The language in these documents describing where Sempra could deliver energy is rather clear and unequivocal. Another Edison document, Exhibit 625, describes Sempra's delivery provisions as "unbelievable." The documents evidence the fact that Edison, the party responsible for managing the Agreement, recognized that Sempra could supply from SP, NP, ZP or any ISO connection point. This is exactly what Sempra contends is permissible under the Agreement.

DWR suggests that the testimony of Mr. Bryson relative to the exhibits mentioned above and Ms. Lee's statements were merely intended to reflect the manner in which Sempra was in practice implementing the agreement. However the plain language of the summaries themselves do not support that view. The testimony of Mr. Bryson on cross examination, supportive of DWR's suggestion, is evasive and not credible in view of his role in the preparation of Exhibit 46. The language of the summaries uses words like "*can* supply from SP," etc., not that they *were* supplying from these points. Furthermore, as attested to by Mr. Bryson himself, the very purpose of the contract summaries was to guide and instruct Edison in what was required under the Agreement. The language used in the summaries cannot be stretched as suggested by Mr. Bryson. The summaries reflected the understanding of the parties "on the ground" as to what Sempra was required to do and could do under the Agreement. The current testimony of both Bryson and Lee appears to be a product of DWR's litigation posture and is inconsistent with their pre-litigation conduct.

DWR suggests the evidence described above is irrelevant or of no evidentiary value, in part because these individuals were not parties to the contract negotiations. Moreover, DWR suggests that this evidence is impermissible lay opinion or speculation by DWR and Edison staff. How the parties conducted themselves before the litigation and after the execution of the Agreement is useful in determining what the parties to the Agreement intended. "In construing contract terms, the construction given the contract by the acts and conduct of the parties with knowledge of its terms, and before any controversy arises as to its meaning, is relevant on the issues of the (parties') intent." *Southern Pacific Transportation Co. vs. Santa Fe Pacific Pipelines, Inc.* (74 Cal.App.4th 1232, 1242, (1999). The manner in which the parties conducted themselves in practice and how they performed under the contract is evidence of what the parties intended. (*Crestview Cemetery Assn. vs. Dieden* (1960 54 Cal.1 2d 744; Witkin, Contracts Sec. 689). The summaries prepared by

Edison clearly set forth the manner in which the parties conducted themselves before the commencement of litigation.

Lastly, DWR contends that Sempra's "plain meaning" argument is inconsistent with the purpose of the Agreement and other provisions. The Panel disagrees. The purpose of the Agreement was to secure a reliable supply of energy to Californians. Sempra's interpretation of permissible delivery points does not prevent the supply of energy into the state. Other provisions in the Agreement likewise do not contradict the "plain meaning" relative to permissible delivery points. DWR sought a reliable supply of energy and that is what Sempra provided.

V. Sempra's Alleged Breach of Section 2.04(C) and/or the Covenant of Good Faith and Fair Dealing Delivering to Congested Points

California's transmission grids are, for the most part, managed by Cal ISO (California Independent Systems Operator). The Cal ISO controlled grid is divided into three "congestion management" zones: NP15 (North of Path 15), SP15 (South of Path 15) and ZP 26.

As part of its grid management responsibilities, Cal ISO receives preliminary "day-ahead" requests for transmission service ("preferred schedules") for each hour of the day preceding the day of energy flow. When such preferred schedules exceed the capability of the system at a particular delivery point, so that congestion is likely to occur, Cal ISO allocated the transmission service by auctioning available transmission through "adjustment bids". An adjustment bid represents the amount of money per megawatt hour that a participant is willing to buy to move power on a congested line. Based on the adjustment bids it receives, Cal ISO sets a market price for congestion, up to a cap of $250/Mwh. If a party does not submit an adjustment bid, it in effect agrees to pay the applicable bid price established at the auction. It will still receive the energy, at that price, except where Cal ISO does not receive enough adjustment bids to resolve congestion problems, or if problems arise in real-time, in which situations all parties' schedules are curtailed on a pro rata basis and the congestion price is set automatically at $250/Mwh.

In addition to the "day-ahead" requests, market participants also submit requests one hour ahead. Cal ISO also manages the "imbalance market," (or "real time spot market"), arranging for the purchase and sale of power from marketers or generators when needed to "balance" the real-time inflows and outflows of power on the grid, such as where loads are more or less than expected, or when a scheduled delivery is unexpectedly reduced.

DWR's complaint is that Sempra routinely and deliberately delivers energy to congested points, such as PV and COB, in order to profit from the lower prices available on the "upstream" side of such points, instead of delivering to less congested points, such as SP15 or at liquid trading points within California. It is undisputed that Sempra takes into consideration potential congestion only to the extent of determining whether its own schedule is compatible with the transmission capacity of the particular line, disregarding all other potential line users, including those holding firm transmission rights ("FTR"), among them Sempra's own affiliate and scheduling coordinator,

SET. On occasion, this has resulted in pro rata curtailments which have prevented a portion of the energy from reaching California. On other occasions it has resulted in DWR (through Edison) being billed for the full amount of the imbalance charges.

DWR contends that Sempra's delivery practice is in violation of its obligations under Section 2.04(c) of the Agreement, and in any event in violation of the implied covenant of good faith and fair dealing. Section 2.04, as relevant, provides as follows:

Section 2.04. *Transmission Scheduling.*

(a) Transmission Scheduling Generally. Seller shall be responsible for and shall arrange transmission service to the Delivery Point. Seller shall schedule or arrange for scheduling services with its Transmission Providers in accordance with the practice of the Transmission Providers to deliver the Energy to the Delivery Point. Department shall be responsible for and shall arrange transmission service at and from the Delivery Point and shall schedule with its Transmission Providers to receive the Energy at the Delivery Point. All deliveries shall be prescheduled, and each Party shall be responsible for ensuring that transmission is scheduled consistent with the most recent rules adopted by the WSSC. SER and Department shall be equally responsible for all Cal ISO imbalance charges associated with this Agreement.

(b) Transmission Curtailment or Interruption Responsibilities. Risks of transmission curtailment or interruption shall be the responsibility of Seller up to the Delivery Point and at and from the Delivery Point to the extent provided for under Section 2.04(c), but shall otherwise be the responsibility of Department at and from the Delivery Point; provided, however, that Seller shall not bear risks of transmission curtailment or interruption that result from (i) Department's failure to take the steps contemplated by Section 2.04(c)(i) and Section 2.0(c)(iii) to prevent or to alleviate transmission curtailments or interruptions, or (ii) unduly discriminatory actions taken by Department.

(c) Response to Transmission Curtailment or Interruption. SER shall make commercially reasonable efforts to provide or cause to be provided for the delivery of Energy at Delivery Points that prevent and/or alleviate existing or potential transmission curtailments or interruptions. SER and Department agree to take the following steps in the following order if and to the extent needed to prevent and/or to alleviate existing or potential transmission curtailments or interruptions that could affect the delivery of scheduled Energy under this Agreement to a Delivery Point and/or transmission of such Energy by Department from that Delivery Point to a point elsewhere within the Associated Cal ISO Delivery Zone: (i) Department shall reduce, interrupt or curtail its sales of Economy Energy; (ii) SER shall or shall cause Seller to reduce, interrupt or

curtail its sales of Economy Energy; (iii) Department shall redispatch or reschedule its power deliveries associated with dispatchable purchases of a duration of twelve (12) months or less to the maximum extent permitted by its power sales contracts; and (iv) SER shall, or shall cause Seller to, make commercially reasonable efforts to deliver the affected portion of the Energy to any other Cal ISO Delivery Point. In the event and to the extent the foregoing measures are insufficient to prevent transmission curtailments or interruptions affecting the delivery of the Energy to a Delivery Point and/or transmission of such Energy by Department from that Delivery Point to a point elsewhere within the Associated Cal ISO Delivery Zone, Seller's obligation to deliver the affected portion of the scheduled Energy to the Delivery Point, and Department's obligation to make payment for that portion of the scheduled Energy, shall be reduced accordingly.

As regards Section 2.04(c), the dispute centers on the meaning of the term "transmission curtailment." Sempra maintains that the term refers to an "unexpected event [which] occurs after final schedules have been provided by the Cal ISO, generally a physical event, causing an unplanned reduction in the capability of the transmission system to handle scheduled flows." DWR, on the other hand, maintains that the term applies also to reductions in proposed (or "preferred") schedules resulting from economic congestion management. The term does not have a "plain meaning," at least to persons outside the industry, and while both parties have attempted to identify an industry understanding of the term, the Panel finds that evidence inconclusive. We consider the disputed phrase in the context of the language of the Agreement which surrounds or relates to it, and its negotiating history.

> DWR points to the other language in Section 204(c) which refers to "unduly *discriminatory actions,*" and to the "prevention and/or alleviation of *potential* transmission curtailments or interruptions." If a "transmission curtailment" is limited to something unexpected that occurs after final schedules have been set, DWR asks rhetorically, how could the curtailment result from "unduly discriminatory actions taken by Department," and how could SER "prevent" it from occurring or "alleviate" it?

Michael Niggli, Sempra's President and a principal negotiator of the DWR agreement, was asked both questions. His response to the first was that there were concerns about ISO allowing DWR representatives into the control room, in a position to obtain non-public information and perhaps to influence ISO's scheduling decisions. That this was a credible concern at the time of the negotiations is evidenced by FERC decisions which address that problem (*San Diego Gas & Elec. Co. V. Sellers of Energy*, 96 FERC par. 61,120 at p. 61,515 (2001); *see* also *Mirant Delta, LLC v. Cal ISOI*, 100 FERC par. 61,271 at p. 22 and n. 23) as well by the Report (02-427) of the General Accounting Office on Restructured Electricity Markets, May 2002, p. 30. This provides a plausible explanation for the choice of contract language, especially in the absence of any

persuasive explanation by DWR of what the anti-discrimination language would mean under its interpretation of "transmission curtailment."

Niggli also offered a suggestion as to how there could be a "potential" transmission curtailment under its interpretation of that term: "where you have a brush fire that may be going underneath transmission lines, and there is an anticipated curtailment that is called for after schedules have been already set. Well, then in accordance with 2.04(c) both parties have to participate in changing their schedules to get the power flows back into a mode where the system will be reliable and stable."

DWR does not dispute that possibility, but argues it is unlikely that the parties spent as much time as they did in negotiating over Section 2.04(c) if its application is limited as Sempra contends. DWR's argument on that score, however, opens other questions. Actual *curtailment* due to congestion of Sempra-supplied energy, as opposed to the incurring of congestion costs, is also a rare phenomenon, since curtailment does not occur so long as DWR pays the congestion charges necessary for transmission.

The negotiating history provides no clear answer to what the language means. There was a good deal of testimony, and some corroborative evidence, as to what each of the parties had in mind with respect to the negotiation of Section 2.04(c) but very little of relevance about what each of the parties communicated to one another, verbally or in writing. DWR argues that since there is some evidence that Sempra knew that DWR had congestion in mind, the burden was on Sempra to clarify the language. But the final language of Section 2.04(c) was drafted by DWR, and the word "congestion" does not appear.

If the contract language and its negotiating history provide doubtful support for DWR's position, the manner in which the parties acted following execution of the Agreement undercuts it substantially. In the early years of the contract, Edison and DWR appear to have acquiesced in Sempra's interpretation of Section 2.04(c). In an internal email message dated February 24, 2003, Doug MacMullen, Mr. Bryson's predecessor as Edison contract manager for the Sempra contract , opined that Sempra was not likely to consider Section 2.04(c) provisions to apply "to a line that is merely congested. I'd guess that they'd claim that congestion is a price-related phenomenon, whereas the provisions of Section 2.04(c) refer to situations (such as equipment failure) wherein the capability of a transmission line is reduced and that 2.03(c) is mainly intended to establish the CERS Sempra Contracts cut-priority." It was not until 14 months later, in April of 2004, that Edison proposed to DWR "new procedures [which] assume that schedule reductions in response to adjustment bids are curtailments or interruptions, as those terms are used in the SER agreement." Edison implemented these "new procedures" when, in May of 2004 (after filing its first Demand in Arbitration) it began to send Sempra daily notices claiming that 2.04(c) was applicable as it now contends.

The actions of the parties under a contract often speak louder than words. (See discussion, *supra*). The Panel concludes that DWR has not shown Sempra to be in violation of Section 3.04(c).

That is not the end of the matter, however. DWR maintains, in the alternative, that apart from Section 3.04(c) the covenant of good faith and fair dealing requires Sempra to take into account the circumstances of congestion in deciding where to deliver Energy under the Agreement, rather than simply ascertaining whether the transmission line is physically capable of carrying the amount of energy Sempra proposes to deliver, and the Panel finds this argument to have merit. "Implicit in every contract is a covenant of good faith and fair dealing that neither party will injure the right of the other to receive the benefits of the agreement." *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 658 (1958). The covenant includes both the duty to refrain from doing that which would render performance impossible and the duty affirmatively to do that which the contract presupposes in order to accomplish its purpose. (*Pasadena Live, LLC v. City of Pasadena*, 114 Cal. App. 4th 1089, 1092 (2004). Sempra insists, correctly, that the covenant cannot be used to vary the terms of the Agreement, but that is not how it is proposed to be used here. Our determination that Section 3.04(c) does not apply to congestion constraints is not inconsistent with the proposition that Sempra has some duty to avoid them. And while the Agreement does give Sempra broad discretion in determining where to deliver Energy, that discretion must be exercised within the framework of the contractual purpose. We conclude that, at the least, the covenant requires that Sempra must not be indifferent to and must take into account what is reasonably knowable about the likely congestion at particular delivery points, that it must cooperate with DWR in seeking to minimize congestion likely to lead to curtailment of schedules, and that it must not deliberately deliver to congested points in order to be able to purchase cheap energy for independent profit.

The evidence strongly suggests that Sempra on many occasions did not act in accordance with these obligations, but the damages evidence in the record is premised on the applicability of Section 3.04(c), and is inadequate to show damage that can be specifically tied to occasions on which Sempra could be said to have breached its good faith and fair dealing obligation as we have defined it. Consequently, the Award will not provide for damages under this heading.

VI. Sempra's Alleged Overcharges

A. Alleged Gas Overcharges

The claimed gas overcharges are charges DWR seeks to recover with respect to amounts it claims have been improperly included in "gas price" and for a declaration of its rights in the future. Both parties rely on Sections 2.02 and 2.03 of the Agreement as authority for their respective positions. Section 2.01 provides that Sempra shall sell and deliver and DWR shall purchase and receive energy at the delivery points and DWR shall pay to Sempra the purchase price. Section 2.02(c) defines "Purchase Price" for the period June 1, 2003 through September 30, 2011 as having the meaning set forth in Section 2.02.

Sempra shall:

"calculate the Purchase Price using the Gas Price determined in accordance with Section 2.03, and the formulas set forth" in Section 2.02(c), "and making adjustments" pursuant to Section 10.07. (2.02(c).

Section 2.03(c) Natural Gas Supply Arrangements provides:

"The Gas Price is intended to reflect the cost of Natural Gas procured by SER to generate Energy under this Agreement, and Natural Gas provided by Department pursuant to an election under Section 2.03(b) (SIC) shall be deemed to be provided to Sempra at no cost. The Gas Price shall be calculated in accordance with the following formula:

$$\text{Gas Price} = \frac{[(S \times Ps) + (B \times P_B)]}{CGR}$$

S, Ps, B, P_B, CGR are terms defined in 2.03(c). Sempra calculates the Gas Price which is then inserted into the formula in 2.02(c) to determine the purchase price.

The purchase price for 7 x 24 energy equals (Gas Price x 7.5 MMBtu per MW-Hour) + $26 per MW – Hour. The purchase price for 6 x 16 energy equals (Gas Price x 10.0 MMBtu per MW-Hour) + $31 per MW-Hour.

In the formula used to calculate the Gas Price S equals the amount of Natural Gas in MMBtu purchased by Sempra pursuant to the Fuel Supply Plan described in Section 2.03(a), times Ps the weighted average price of S in dollars per MMBtu for the billing period.

Apparently Ps has been calculated by Sempra combining the various costs Sempra is required to consider in proposing to DWR a Fuel Supply Plan for a fuel supply year. These costs apparently are the cost of Sempra providing Natural Gas and associated Natural Gas transportation, distribution, storage and/or other delivery services. 2.03(a).

Sempra's proposed Fuel Supply Plan for the first billing period 6/10/03 – 12/31/03 (Exhibit 409) provides that its Supply Plan uses as a starting point for the price of the gas itself indicative pricing based upon indexes plus "MAX.RATETRANSPORT plus $0.0200/MMBtu" and, with respect to deliveries, to Topock and SW Gas specific $/MMBtu. As part of this Fuel Supply Plan Sempra proposed that not more than 60,000 MMBtu/d would be priced utilizing a combination of fixed and/or indexed daily prices.

In Section 5.0 entitled "Natural Gas Scheduling" of the first Fuel Supply Plan Sempra advises it has contracted for scheduling and managing Natural Gas deliveries associated with the delivery of Energy to DWR. The scheduler is not identified.

In Section 6.0 entitled "Expected Use and Cost of Transportation, Distribution, Storage and other Delivery Services," Sempra advises in a paragraph entitled "Project(s) Known Existing Natural Gas Cost Components" that with respect to the Mexicali Project Sempra has long-term contracts for the transportation of gas on North Baja and Gasoducto. The costs associated with this firm transportation are approximately $0.33MMBtu and are included in the gas cost summary calculations below." It also provides that with respect to the Mesquite Project there is a 6.3 percent fuel tax charged by the State of Arizona for fuel consumed in the process of generating electricity in Arizona.

Each project included with the 2003 Fuel Supply Plan includes a summary referencing transportation, distribution, storage and/or other delivery services associated with gas deliveries to the specific project identified in the plan and a Sample Cost Calculation (illustrative only) which list includes transportation, demand, commodity, ACA & GRI. (ACA is a FERC charge and GRI is a charge for Gas Research Institute.)

October 2, 2003 Sempra submitted a proposed Fuel Supply Plan for the 2004 fuel supply year.

The proposed Fuel Supply Plans 2003, 2004 and 2005 are the same with exceptions not relevant in deciding the issues before the Panel.

Each period's Fuel Supply Plan (2003 – 2005) use such terms as "indicative" pricing, "index" pricing, and "final" pricing.

Sempra calculates the purchase price using the Gas Price which it has calculated using information contained in its Fuel Supply Plan. The "Gas Price" and "Purchase Price" are determined by Sempra.

The Fuel Supply Plan submitted each year serves two purposes. It is to:

> "...provide information as to how Sempra intends to procure Natural Gas and associated Natural Gas transportation, distribution, storage and/or other delivery services such that Department can evaluate the Fuel Supply Plan in order to ascertain the expected cost of Natural Gas needed to generate Energy sold under this Agreement." 2.03(a).

The second purpose of the Sempra Fuel Supply Plan requires Sempra:

> "...to act in accordance with the Fuel Supply Plan." 2.03(a).

DWR has taken issue with each Fuel Supply Plan, objecting that it does not provide the information needed by DWR to evaluate it in order to ascertain the expected cost of gas as needed to generate energy under the Agreement.

Beginning with the Fuel Supply Plan for the year 2003, there is a term sheet for the "Mesquite Project," "Mexicali Project," " Eldorado Project," and "Elk Hills Project." Each sheet has "sample cost calculations." The sample cost calculations do not show a charge for Arizona use tax, SET fees, or down-stream transportation and distribution charges for North Baja.

The calculations of the Purchase Price of Energy and the Gas Price lies with Sempra. DWR is not given in the Agreement any right or responsibility to make those calculations. They are the right and responsibility of Sempra acting in accordance with the Agreement.

DWR was on notice commencing with the 2003 Fuel Supply Plan by Sections 5.0 and 6.0 of the Fuel Supply Plan that Sempra was contracting for scheduling, had long-term contracts for the transportation of gas on North Baja and Gasoducto to the Mexicali Project, and that there was a State of Arizona fuel tax for fuel consumed at Mesquite.

DWR seeks damages in the amount of $21 million for recovery of the Arizona fuel tax paid by DWR to Sempra for the period June 2003 through February 2005. This amount was a calculation by Sempra's expert Dr. Robert Weiner, who calculated that amount of overcharges on DWR-supplied gas to be $4.9 million and for Sempra-supplied gas to be $16.1 million DWR accepted this figure.

DWR seeks damages in the amount of $774,000 for the sum of all SET scheduling, nominating and balancing charges passed through to DWR for the period June 2003 to February 2005.

DWR claims damages in the amount of $6.1 million for the period January 2004 through February 2005 for the alleged overcharges resulting from the delivery of gas paid by DWR to Sempra for delivery from the North Baja and Gasoducto pipelines to Sempra's Mexicali plant in Mexico. Included, apparently, in this figure is some amount for gas deliveries to the Kern-Blue Diamond delivery point.

DWR claims that it has improperly paid Sempra delivery charges on the Energy billed by ISO to Sempra for transmission losses between Imperial Valley 230-kV to SP15 in the amount of $8.3 million through August 2005.

DWR seeks damages for uncompetitive prices paid to Sempra exclusive of charges for the Arizona fuel tax charges, scheduling, nominating and balancing charges, transmission and distribution from North Baja. These charges are claimed to result from paying above market prices for gas and transportation.

With respect to each claim DWR seeks recovery through April 2006.

In addition to recovery of damages, DWR has requested a declaration of its rights. We will now address whether or not these claimed overcharges set forth above are appropriate within the meaning of the Agreement.

1. Arizona Fuel Use Taxes

The Arizona tax is imposed on the consumption of gas supplied to Sempra at its Mexicali generating station in Arizona. The tax arises when the gas is burned, that is, consumed. There was testimony by Sempra that there were no storage facilities for the gas at Mexicali so the imposition of the tax occurred on the consumption of the gas.

The State of Arizona statute provides:

> "... imposed an excise tax on the storage, use or consumption in this State of tangible personal property purchased from a retailer or utility business as a percentage of the sale price." (ARS §42-5155)

DWR contends that since the Arizona tax is a tax on consumption and not a tax imposed on the procurement of gas, the tax should not be included as a part of the "Gas Price." DWR contends that the tax is imposed on the consumption and that consumption takes place prior to the "Delivery" of energy to DWR but after it has been received by Sempra. It says that Sempra is responsible for all costs up to the delivery point so DWR has no responsibility for the tax under the Agreement. Accordingly, DWR should not be charged the amount of the tax.

Stated another way, it is DWR's position that the gas has been delivered, the manufacturing process has started at which point the tax is imposed. It becomes Sempra's obligation just as Sempra is obligated for labor, materials, overhead, and the other expenses arising out of the production of the Energy. Further, consistent with this position, DWR says it has no responsibility for reimbursing the Arizona tax paid by Sempra on Sempra-self supplied gas as well as DWR-supplied gas.

DWR believes that its position is strengthened by Section 10.07 "Taxes." It claims that pursuant to that section, Sempra is required to pay for all out-of-state taxes "applicable to energy that arise prior to the 'Delivery Point'." It contends that the drafting history of this section supports its position.

It is Sempra's position that it is entitled to recover all costs to the "burner tip" when it supplies the gas and that it also should be entitled to reimbursement for the tax when DWR supplies. It argues that there should be no rationale for a different result on the gas supplied by DWR. It is Sempra's position that the testimony by Mr. McElroy established that Sempra was to be financially indifferent as to whether or not DWR self-supplied the gas. It argues that if Sempra is to be indifferent, then it must be able to pass through the same costs to DWR, regardless of whether DWR elects to self-supply or Sempra supplies. It says that if it was unable to collect such

charges from DWR, there would be no point in a Fuel Supply Plan because it would always be cheaper for DWR to make an election to self supply.

Sempra argues that DWR presented no testimony that the fuel tax should be treated any differently than other "burner-tip" costs that DWR was willing to accept. Sempra contends that Section 10.07 applies only to taxes on energy and not a tax such as the Arizona use tax.

Both parties believe that the phrase in 2.03(c), that in the case DWR self-elects:

> "Natural Gas provided by Department pursuant to an election under Section 2.05(b) (SIC) shall be deemed to be provided to Sempra at no cost"

supports their respective positions.

Discussion

The tax is on consumption. It does not arise until the gas is consumed. We find the term "burner tip" not helpful in answering the question before the Panel. "Gas Price" includes transportation, distribution, storage and/or other delivery services properly included in arriving at the "Gas Price." The term "burner tip" is not used in 2.03(a) or in the definition used in the formula to calculate "Gas Price," A determination of the meaning of Section 10.07 is not necessary to our decision.

The tax is not part of the "Gas Price" as used by the parties, that is, what is paid by SET on behalf of Sempra to secure the product, nor is it a transportation, distribution, storage or other delivery services expense. The tax on consumption is not recovered through the operation of the formula making up the purchase price of energy transportation, distribution storage and/or other delivery services.

Sempra's expenses are recovered or not recovered through the demand charge ($26 or $31 per MW-Hour) or through the operation of the heat recovery factor (7.5 MMBtu per MW-Hour or 10.0 MMBtu per MW-Hour). We find that Sempra is responsible to the delivery point and since the tax occurs on consumption, which is before the delivery point to DWR, DWR should not be billed for the Arizona tax.

DWR is entitled to recover $21 million, which figure should be recalculated to include the amount paid by DWR to Sempra to date, including statutory interest.

2. Scheduling, Nominating, and Balancing Charges

DWR claims that Sempra includes within the monthly invoice from Sempra in the "CDWR Gas Price" a monthly charge passed on by SET to Sempra for the scheduling and managing by SET of Natural Gas deliveries associated with the delivery of Energy to Sempra. It is DWR's position

that the only charges Sempra may pass through to DWR are those incurred in procuring Natural Gas, transportation, distribution, storage and other delivery services.

DWR claims that Sempra's own Fuel Supply Plans concede this point. DWR says that Section 6.0 of each Fuel Supply Plan is titled "Sempra's Expected Use & Cost of Transportation, Distribution, & Delivery Services" and that none of these sections refer to the SET charges at issue. Rather, Sempra describes SET's charges in Section 5.0 of each Fuel Supply Plan which it titles "Natural Gas Scheduling." DWR claims that moreover, in the project-specific cost breakdown in Section 7.0 of each year's Fuel Supply Plan, Sempra charts include "estimated costs for Natural Gas, transportation, distribution, storage and/or other delivery services...", none of which lists the SET charges about which DWR complains.

DWR claims that there is no dispute that Sempra passes these charges monthly to DWR and that, while Sempra's invoices do not reveal the pass-through of the SET charge, the charge is built into the table listing the "CDWR Gas Price" for each month. According to DWR it was charged monthly on the entire CGR even though it elected to self-supply 80 percent of the CGR.

DWR seeks damages equal to the sum of all SET scheduling, nominating, and balancing charges passed through to DWR. The amount claimed, without interest for the period June 2003 – February 2005, is $774,000.

It is Sempra's position that there is no basis for DWR's arguments as these costs are reflected in the Fuel Supply Plans, and are properly included as costs of procurement.

Discussion

We conclude that charges for scheduling, nominating, and balancing charges are not captured by the language "Natural Gas, transportation, distribution, storage and/or other delivery services" in Section 2.03(c). They do not appear in the Fuel Supply Plan in the breakdown of the "estimated costs for Natural Gas, transportation, distribution, storage and/or other delivery services." See for example, 2004 Fuel Supply Plan, Exhibit 418 DWRA 0000587-90. It is, of course, correct that in the text in Section 5.0 Natural Gas Scheduling it is stated "Sempra has contracted the services of an energy services company for purposes of scheduling and managing Natural Gas deliveries and associated with the delivery of Energy to the Department. The cost of these scheduling services will be up to $37,500 per month." However, the costs do not appear as a separate item on the term sheets.

It is also troublesome that not only are the amounts being paid to a Sempra affiliate but Sempra is claiming that DWR should also pay with respect to the DWR-supplied gas. The heat rate multiplier is applied against the SET monthly charge, which results in SET/Sempra not only being compensated for the cost of scheduling, nominating, and balancing but also a profit price on top of the charges. The matter is further complicated by reason of the many functions being performed by SET on behalf of Sempra, including buying and selling of electricity as well as gas

and further the scheduling of the energy produced by the Sempra plants. SET performs these functions for Sempra with respect to more than the energy supplied to DWR.

The fact that Oxy included certain charges in its proposed invoice does not mean that it contains the same elements as SET's. Sempra's position that these costs are reflected in the Fuel Supply Plan is not dispositive of the matter. "Gas Prices" includes transportation, distribution, storage and/or other delivery services. There is nothing in this definition to support the propriety of charges for scheduling, nominating, and balancing.

Based upon the record in this proceeding, we find that the scheduling, nominating and balancing charges should not have been passed on to DWR and should not be in the future. DWR is entitled to recover through February 2005 $774,000, which figure should be recalculated to include the amount paid by DWR to Sempra to date including statutory interest.

3. Transportation and Distribution Charges on DWR-Supplied Gas

DWR has delivered gas to the interconnection with North Baja pipeline in Arizona as required by Section 1.01 "Southern California Border Point" of the Agreement, and from there Sempra ships some of the gas over the North Baja and Gasoducto pipelines to its Mexicali plant in Mexico. DWR says that Sempra impermissibly included those pipeline charges in its calculation of the Gas Price. It says that the Gas Price formula has only two price variables and neither applies in this situation.

DWR says that Sempra argues that it is allowed to pass through the shipping charges because otherwise, it would not be neutral as to whether to supply the gas, but would actually have a financial incentive to supply one-hundred percent of the CGR.

DWR says that the only evidence in the record on this point is Mr. McElroy's testimony that Sempra is indifferent as to whether it supplies gas. It says that Mr. McElroy's testimony is based on the assumption that the charges at issue may be passed on to DWR.

In a footnote DWR claims that Sempra also added some similar distribution charges into its calculation of the Gas Price with respect to some DWR deliveries to the Kern-Blue Diamond delivery point. It points out that during negotiations Sempra gave up the right to include any "transportation adder" in the Gas Price.

It says that Sempra's invoices do not reveal the pass through of the additional shipping charges to Mexico, that it is built into the table listing "CWR Gas Price" for each day of the month. It claims that the amount of these charges is $6.1 million for the period January 2004 to February 2005.

Sempra in its December 13, 2005 memorandum takes the position that it is entitled to its burner tip transportation costs when Sempra supplies the gas. It says there can be no rationale for a

different result on the gas self-supplied by DWR. It is Sempra's position that it is entitled to include all burner-tip costs.

Sempra in its Post Arbitration Brief does not seem to make any specific reference to this claim of DWR's. However, it would also seem to be clear that it is its position that it believes it is entitled to pass through all costs up to the "burner-tip." It further stated in oral argument on December 13, 2005, DWR said that, with the exception of the Arizona fuel tax, DWR was agreeing that Sempra was entitled to a pass through all of these costs when Sempra supplies the gas commodity. Sempra takes the position that it makes no sense to treat DWR self-supply differently.

Discussion

We find that as a matter of contract interpretation DWR's obligation ceases when it delivers the self-supplied gas to the North Baja pipeline, the delivery point specified in the Agreement. We find that the Gas Price formula has only two variables and this matter does not fall within either one.

Sempra's reliance on Mr. McElroy's testimony that Sempra was indifferent as to who supplies gas because the charge "may be passed through" is not persuasive. The question is what does the contract say, and in this case it is clear. Sempra should not have charged for these shipping charges and should not have included them in its calculation of "Gas Prices."

Sempra takes the position in its brief that DWR dropped its claim for recovery of transportation costs. The record is ambiguous at best. It is not clear that the parties were talking about the invoices. However, it does not matter. The claim is covered by the Second Amended Demand, testimony was offered, post-hearing briefs were submitted and both stated their respective positions on the merits. We find that the Contract does not permit Sempra to charge for these costs.

We find that the these delivery charges should not have been included and are not recoverable in the future. DWR is entitled to recover through the period February 2005 $6.1 million, which figure should be recalculated to include the amount paid by DWR to Sempra to date including statutory interest.

4. Above Market Prices for Gas and Transportation Charges

DWR claims it has been damaged in that it was required to pay an unnecessary premium over prevailing market prices for natural gas supplied by Sempra. The amount of its claim is calculated by comparing the actual amount paid by DWR for self-supplied gas with two broad indices of natural gas prices in Southern California. It used a monthly and daily index for "Southern California Border Prices." The amount claimed was reduced by DWR by subtracting from the claimed overcharges the amounts sought for the Arizona fuel use taxes, SET fees for

scheduling, nominating and balancing, and downstream transportation and distribution charges (North Baja, et al.)

It is Sempra's position that DWR's analysis contained errors and that when these errors were corrected there was no overcharge and, in fact, DWR was charged $4,390,838 below market rates. It was Sempra's position that the use of the Southern California border indexes was not an appropriate market measure for all gas deliveries in that it did not reflect the price differential or premium for three of the gas delivery points. It was Sempra's position that there is a "Southern System Premium" over the established Southern California border index price. It says that DWR's only witness on this issue acknowledged that there was price pressure on the supply from the Permian basin.

Discussion

We find that based upon the record in this proceeding DWR has not proved that it paid an unnecessary premium over what it describes as prevailing market prices. Nor has it shown that it has been overcharged by Sempra through SET's passing through unrecoverable gas and transportation prices, exclusive of the amounts which we find are appropriate for recovery of the Arizona taxes, SET fees, and downstream charges (North Baja, et al.)

B. Energy Overcharges

1. Mexicali Transmission Losses

According to DWR, for approximately two and a half years Sempra has been delivering energy to DWR at SP15 instead of delivering it to Imperial Valley 230-kV. Charges are imposed by the Cal ISO on energy transmitted between Mexicali and SP15. According to DWR, the Cal ISO bills Sempra's scheduling coordinator, SET, for the imbalance energy necessary to offset the line losses included in transmitting the energy from Mexicali to SP15. According to DWR, for two and a half years Sempra has been passing on these charges without supporting documentation. DWR claims the charges are imposed prior to actual delivery and that under Section 2.01 Sempra is responsible "for any costs or charges imposed on or associated with Energy up to the Delivery Point."

DWR says that Sempra argues that because the contractual delivery point for deliveries from Mexicali is Imperial Valley SP15, it has made the deliveries under the terms of the Agreement.

DWR says that Section 2.05(c) permits Sempra to deliver energy from a project at any Delivery Point, not just the Delivery with which that project is associated. It says that Section 1.01 defines "delivery point" as any of the points of delivery listed in Appendix B (Column D) or any Alternative Delivery Point.

It argues that the parties have acquiesced in Sempra's deliveries at SP15, which makes SP15 a mutually agreed Alternative Delivery Point for deliveries of Energy from Mexicali.

DWR says that as a result of the operation of Section 2.06, Sempra is solely responsible for all costs, including transmission costs associated with transmitting the Energy from Imperial Valley 230-kV to SP15.

DWR says that the energy is not delivered to DWR at Imperial Valley and, in fact, Sempra on its final daily notices lists SP15 as the delivery point for Mexicali deliveries. It says that Section 10.01 makes clear for the purposes of the Agreement that a Delivery Point is a point at which title transfers.

Sempra claims that DWR presented no evidence at the hearing to explain why its obligation to pay these loses at Mexicali differed from its conceded obligation to pay for transmission loses at and from the delivery point for plants other than Mexicali.

DWR says that Sempra simply misses the mark; that DWR does not dispute its obligation to pay for transmission losses from the delivery point. What it disputes with respect to deliveries from Mexicali, and only with respect to deliveries from Mexicali, is the identification of the "Delivery Point" for purposes of the Agreement. Thus, evidence that DWR paid without protest transmission loss charges for power deliveries from other plants is irrelevant.

DWR says that Sempra's claim that it has not disputed the accuracy of the amounts charged for Mexicali losses is "simply false." It said that it complained repeatedly. That even if the charges had been its responsibility, they were completely unverified and that Sempra has consistently refused to provide to DWR meter data necessary to validate the Mexicali loss charges. There is no dispute that the amount involved is $8.3 million through August 2005.

It is Sempra's position that under the Agreement, Sections 2.01 and 2.04(a), DWR is responsible for transmission losses at and from the delivery point and that DWR pays for transmission losses at and from delivery points for all other plants.

Sempra says that the difference with the Mexicali plant is that because of Cal ISO protocols the scheduled point is different from the contractual and physical delivery point. It says that the Agreement provides that the delivery point for the Mexicali plant is Imperial Valley 230-kV, the point of interconnection for the plant with the Cal ISO Grid, through which all power generated at Mexicali passes. It says that the Cal ISO requires however, that power from Mexicali be scheduled to SP15 because the Mexicali plant is defined as within the Cal ISO Grid.

Sempra says that "DWR argues that the Cal ISO protocols make it impossible for Sempra to deliver power from Mexicali to Imperial Valley 230-kV. This is incorrect. Sempra cannot schedule into Imperial Valley 230-kV because of Cal ISO rules. But the Cal ISO's protocols do not affect the contractual Delivery Point or the contractually-agreed point of the transfer."

It is Sempra's position that the schedules list Imperial Valley 230-kV as the delivery point and SP15 as the scheduling delivery point, which is consistent with its position.

Discussion

Sempra delivers energy from its Mexicali plant to DWR at SP15 rather than the delivery point Imperial Valley 230-kV specified in the Agreement (Definitions, Appendix B, Column D or any Alternative Delivery point 2.06). The ISO bills Sempra for the imbalance energy it supplies to compensate for line losses from Imperial Valley 230-kV to SP15. Sempra has been collecting the amount it pays ISO from DWR.

We find that the energy is delivered to DWR at SP15. The fact that the ISO has designated SP15 as the delivery point and the parties have accepted that designation would make SP15 the de facto or Alternative Delivery Point. Also, DWR has been unsuccessful in receiving verification by meter data of the loss charges.

We find that in the future Sempra shall treat SP15 as the delivery point under the Agreement. DWR is entitled to recover $8.3 million through August 2005, which figure should be recalculated to include the amount paid by DWR to Sempra to date including statutory interest.

2. Energy Undelivered Due to Plant Outages

DWR has alleged that Sempra has improperly charged it for energy which was not delivered to it when one of Sempra's generating plants was subject to an unexpected plant outage or deration. On the occurrence of these events, Sempra's deliveries were "made whole" by delivery of energy from the imbalance market operated by Cal ISO. When these events occurred, Sempra would bill DWR for the full contract price and Sempra would be invoiced by DWR for the imbalance charges. This was the manner in which the contract was implemented in early 2002. When DWR received the energy from the imbalance market, it was in no different position financially or operationally than had the energy been delivered by Sempra. In the end, DWR received the scheduled energy and paid no more than the agreed upon contract price.

This method of operation was in accordance with the agreement and understanding that Sempra had with DWR. In an email dated March 29, 2002 from Hank Harris, the scheduling coordinator for Sempra to Susan Lee, the scheduling coordinator for DWR, he wrote: "Per our phone conversation this morning, we have agreed to the following regarding scheduling and replacement power for Sempra Energy Resources:...CERS [DWR] will be kept whole for the energy on these schedules through the ISO imbalance market (probably up to three hours). The original schedules will still be deemed delivered, and CERS will bill SER directly for the replacement costs associated with the imbalance energy that CERS is charged for by the ISO." Lee did not respond to this email at that time. However, there was confirmation of this agreement by DWR's actions after March 29, 2002. DWR did in fact invoice Sempra in April 2002 for 32 MWh and May 2002 for 144 MWh, which invoices were paid by Sempra. It was not until June 13, 2002

that Susan Lee questioned this procedure in response to a June 12, 2006 email from Hank Harris asking CERS to bill Sempra for a June replacement of power. In response to Harris' email, Ms. Lee questioned the understanding and asked for documentation. Harris then reminded Lee of the March 29th agreement. Lee asked for a copy of the March 29th email with the comment that the issue "seems to be open to legal interpretation." Thereafter, DWR stopped invoicing Sempra for the ISO imbalance charges and took a different position with respect to this issue. Contrary to the operating procedures agreed to on March 29th, DWR now took the position that where there were plant outages or derations, and the schedules were made whole through the Cal ISO imbalance market, DWR was not obligated to pay Sempra at all. In this arbitration DWR seeks repayment for the payments made to Sempra.

To support its contention, DWR argues that the energy supplied through the Cal ISO is not "Energy" as defined under the Agreement. It further argues that energy supplied through the Cal ISO is "neither provided by Capacity as described in Appendix C and defined in Section 1.01, nor "prescheduled" as required in Section 2.04(a) and further, energy supplied through the Cal ISO does not come from either a "Project" or a "Market Source" as those terms are defined in Section 1.01." DWR's position is inconsistent with the manner in which the parties understood the obligation under the Agreement and is incorrect.

Sempra is correct in its contention that it is permissible for it to use the ISO imbalance market to meet its schedules when there is a plant outage or deration. First of all, that is how the parties understood the Agreement as exemplified by the March 29, 2002 email and the subsequent invoices which resulted from that understanding. Secondly, the Agreement respectfully provides Sempra with the right to supply power from "market sources" which is defined as "any marketer, trader, seller, or generator." Philip Hanser, DWR's damage expert agreed that the imbalance market "is a market." Concededly, Cal ISO does not generate power. When the Cal ISO makes the Sempra schedules whole through the use of the imbalance energy it necessarily obtains it from a market source, which is a source permitted under the Agreement. Sempra therefore, has satisfied its contractual obligations by delivering energy from market sources and was entitled to payment. Sempra has acknowledged that whatever Cal ISO has charged DWR for the imbalance energy to meet Sempra's schedules is Sempra's responsibility. As previously mentioned DWR invoiced Sempra for these charges for April and May of 2002, but stopped this practice and thereafter refused to forward these charges to Sempra. DWR's expert report set the amount of these imbalance charges which showed an additional amount due from Sempra. Sempra thereafter paid DWR $576,674 which represented all of the imbalance charges. There is no further payment due from Sempra.

The Panel therefore finds that Sempra has not breached the Agreement in the manner alleged. DWR's stated objectives in entering into the Agreement were to avoid exposure to the volatile spot market. The Agreement reached in March 2002 satisfied DWR's concerns. DWR was never obligated to pay more than the agreed upon contractual price for energy and Sempra assumed the risk for the imbalance or spot market whether such prices were higher or lower than the contract price.

VII. DWR's Claim for Rescission

DWR contends that Sempra has engaged in a pattern of egregious, material, and bad faith breaches of the Agreement which go "to the very roots of the contract" (*Crofoot Lumber, Inc. v. Thompason* (1958) 163 Cal.App.2d 324, 333, making rescission appropriate. In DWR's view, Sempra's asserted breaches have frustrated the basic objectives of the relationship – to provide reliable, cost-effective energy for California consumers – and the differences between the parties are so extensive and serious that, no matter what other relief is provided or declared, continuing controversy is predictable. DWR wants a divorce.

The Panel has, indeed, found in favor of DWR's position with respect to certain of its claims. In each such instance, however, the controlling contract language has been found to be ambiguous and subject to reasonable differences in interpretation. Moreover, leaving aside conflicting contentions of good and bad faith, DWR has not always been diligent in pursuing the procedures provided by the Agreement for the resolution of disputes as they arise. Unlike the *Crofoot* case upon which DWR relies, this Agreement is for a fixed and substantial term. Sempra has made substantial capital investments in reliance upon it. It is likely that disagreements will arise in the future, but there is no reason to believe that they will be incapable of resolution through the contractual procedures, including arbitration if necessary.

Rescission is an equitable remedy, which requires consideration of various factors, including "(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected; (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived; (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture; (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking into account all the circumstances including any reasonable assurances; (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing." (ALI Restatement (2d) of Contracts, Sec. 241).

Upon consideration of all relevant factors, the Panel concludes that rescission is not warranted.

AWARD

With respect to each of the issues in dispute, the Panel finds, declares, and awards as follows

I. Sempra did breach its obligations under Section 2.05 of the Agreement by failing to comply with its Annual and Monthly Energy Delivery Plans. Variations from the annual and monthly plans are not permissible except when due to circumstances, such as plant outages, that are beyond Sempra's control. For this breach DWR is entitled to damages in the amount of $1,506,554.

II. Sempra is in breach of its obligations under the Agreement by failing to provide Fuel Supply Plans that would enable DWR reasonably to predict the cost of gas. DWR is not entitled to damages for this breach, but the parties are directed to meet and confer over future Fuel Supply Plans in accordance with the principles expressed in the foregoing Opinion.

III. Sempra did not breach its obligations under the Agreement by failing to provide Energy in contractually required quantities and product types as alleged by DWR.

IV. Sempra did not breach its obligations under the Agreement by delivering Energy to impermissible delivery points as alleged by DWR.

V. Sempra did not breach its obligations under Section 2.04(c) of the Agreement as alleged by DWR, but it did breach the implied covenant of good faith and fair dealing by the manner in which it delivered Energy to congested points. DWR has not proved recoverable damages for this breach, but in the future Sempra must not be indifferent to and must take into account what is reasonably knowable about the likely congestion at particular delivery points; it must cooperate with DWR in seeking to minimize congestion likely to lead to curtailment of schedules; and it must not deliberately deliver to congested points in order to be able to purchase cheap energy for independent profit.

VI. With respect to the various claims of improper charges by Sempra:

A. With respect to gas:

1. Sempra is responsible for payment of Arizona Fuel Taxes, and DWR is entitled to recover from Sempra $21 million which was improperly billed for such taxes for the period June 2003 through February 2005, which figure should be recalculated to include the amount paid by DWR to Sempra to date, including statutory interest calculated from the date of each payment.

2. Sempra is responsible for payment of SET scheduling, nominating, and balancing fees, and DWR is entitled to recover from Sempra amounts improperly billed for such fees in the amount of $774,000 for the period June 2003 through February 2005, which figure should be recalculated to include the amount paid by DWR to Sempra to date, including statutory interest calculated from the date of each payment.

3. Sempra is responsible for payment of downstream transportation and distribution charges, and DWR is entitled to recover from Sempra

amounts improperly billed for such charges in the amount of $6.1 million for the period January 2004 through February 2005, which figure should be recalculated to include the amount paid by DWR to Sempra to date, including statutory interest calculated from the date of each payment.

4. DWR has not proved that Sempra has been charging above-market prices for gas and transportation.

B. With respect to Energy:

1. Sempra is responsible for Mexicali transmission losses, and DWR is entitled to recover from Sempra amounts improperly billed in the amount of $8.3 million for the period June 2003 through August 2005, which figure should be recalculated to include the amount paid by DWR to Sempra to date, including statutory interest calculated from the date of each payment.

2. Sempra did not improperly charge DWR for Energy which was not delivered to it when one of Sempra's generating plants was subjected to an expected plant outage or deration.

VII. None of Sempra's breaches, individually or collectively, constitute a material breach justifying rescission of the Agreement.

This Order and Award is in full settlement of all claims submitted in this arbitration. All claims of the parties submitted in this arbitration which are not specifically referred to in this Opinion and Award are disallowed.

The administrative fees of the American Arbitration Association shall be borne equally by the parties as incurred, as well as the compensation of the arbitrators.

It is so ordered this 18th day of April 2006.

Hon. Joseph R. Grodin (Ret.)

Hon. Edward A. Panelli (Ret.)

Samuel H. Porter, Chair of the Panel